DEPARTMENT OF STATE REVENUE

04-20210007.SLOF;
04-20210008.SLOF;
04-20210040.SLOF

Supplemental Letter of Findings: 04-20210007; 04-20210008; 04-20210040
Gross Retail and Use Tax
For the Years 2017 and 2018

NOTICE: IC § 6-8.1-3-3.5 and IC § 4-22-7-7 require the publication of this document in the Indiana Register. This document provides the general public with information about the Department's official position concerning a specific set of facts and issues. This document is effective on its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register. The "Holding" section of this document is provided for the convenience of the reader and is not part of the analysis contained in this Supplemental Letter of Findings.

HOLDING

The Department agreed that Restaurant Chains established that utilities consumed by their microwave oven, fry freezer, and holding cabinets were exempt from sales tax on the ground that the ovens, freezers, and cabinets had a direct, transformational effect within Restaurant Chains' integrated production of its products; however, the Department did not agree that equipment which sustained food in its then present state was also exempt.

ISSUE

I. Gross Retail and Use Tax - Utilities Consumed in Preparing Food.

Authority: IC § 6-2.5-2-1; IC § 6-2.5-3-2; IC § 6-2.5-5-5.1; IC § 6-8.1-5-1; *Dept. of State Revenue v. Caterpillar, Inc*., 15 N.E.3d 579 (Ind. 2014); *Aztec Partners, LLC v. Indiana Dep't of State Revenue*, 35 N.E.3d 320 (Ind. Tax Ct. 2015); *Indiana Dept. of State Revenue v. Rent-A-Center East, Inc*., 963 N.E.2d 463 (Ind. 2012); *Lafayette Square Amoco, Inc. v. Indiana Dept. of State Revenue*, 867 N.E.2d 289 (Ind. Tax Ct. 2007); *General Motors Corp. v. Indiana Dept. of State Revenue*, 578 N.E.2d 399, 404 (Ind. Tax Ct. 1991); *Mynsberge v. Dep't of State Revenue*, 716 N.E.2d 629 (Ind. Tax Ct. 1999); *Tri-States Double Cola Bottling Co. v. Dep't of State Revenue*, 706 N.E.2d 282 (Ind. Tax Ct. 1999*);* 45 IAC 2.2-3-4; 45 IAC 2.2-4-13; Letter of Findings 04-20210007; 04-20210008; 04-20210040 (June 22, 2021).

Taxpayers argue that the Department erred in denying them a portion of their original refund requests and in assessing additional sales tax.

STATEMENT OF FACTS

Taxpayers own and operate chains of fast-food restaurants located throughout the state of Indiana. By means of consolidated returns, Taxpayers pay sales tax on purchases of items used in the restaurants and also routinely collect and remit sales tax from their restaurant customers.

Taxpayers submitted refund claims for tax paid on the purchase of utilities. The Indiana Department of Revenue ("Department") reviewed the claims and "adjustments were made" because that review "revealed discrepancies in the equipment listed as exempt."

The purported discrepancies arose when the Department determined that certain items of the equipment - such as freezer and freezer evaporator - were not involved in the "direct processing of the food sold by the [T]axpayer]."

The Department's decision had two results; a portion of Taxpayers' most recent refund claim was denied, and additional tax was assessed. The tax was assessed to recoup a portion of the refund previously and erroneously granted to Taxpayers on the same issue.

In addition, the Department issued Taxpayers' utility vendors a "revocation letter" for restaurant locations which were previously classified as "predominately exempt." These particular locations were no longer entitled to a 100 percent exemption but were now entitled to a lesser percentage amount based on the actual quantity of exempt utilities consumed.

Taxpayers disagreed with the Department's decisions and submitted a protest to that effect. An administrative hearing was conducted during which Taxpayers' representatives explained the basis for the protest. A Letter of Findings was issued June 2021. The Department agreed that Taxpayers' Cadco Convection Ovens were exempt from sales tax because the "ovens had a direct, transformational effect on the [Taxpayers'] food products." However, the Letter of Findings disagreed "that equipment which simply sustained food in its then present state was also exempt."

Taxpayers disagreed with the Letter of Findings, asked for and was granted a rehearing, and a follow-up hearing conducted. This Supplemental Letter of Findings results. For simplicity's sake, the Taxpayers are hereinafter referred to simply in the singular as "Taxpayer."

I. Gross Retail and Use Tax - Utilities Consumed in Preparing Food.

DISCUSSION

The issue is whether Taxpayer has met its burden of proof needed to establish that five items (or categories) of equipment are being directly used by Taxpayer in the direct production of its food products and that - as a result - utilities consumed by that equipment were exempt from sales and use tax.

A. The Department's Audit Review.

The Department's audit representative toured three of Taxpayer's restaurant locations. According to the audit report, "The taxpayer was in agreement to tour these three locations and appl[ied] the results to all the locations" included in Taxpayer's three operating restaurant divisions. Taxpayer apparently agreed because "all locations have a standard equipment package."

The audit report indicated that the three locations had a "walk in freezer, walk in freezer evaporator, walk in cooler evaporator, holding cabinet, heat lamp, three microwaves and a convection oven . . . ." In each case, the Department concluded that these devices are not involved in "direct processing of the food sold by the taxpayer." The audit report explains as follows:

> This equipment is not exempt because it is used to store the received frozen inventory, keep the heat on finished processed food, and reheat finished processed food.

The audit allowed an exempt percentage for each of the restaurants but "[t]he equipment included by the taxpayer which is not exempt equipment has been removed . . . ."

As noted above, the audit resulted in a partial denial of the refunds originally requested and "tax is assessed back on the refund given for January-May 2017." However, the audit refunded tax "for the gas charges during this period where tax was charged, and no refund requested."

In effect, Letter of Findings 04-20210007; 04-20210008; 04-20210040 (June 22, 2021), 20210825-IR-045210362NRA, agreed with the audit's original analysis but found - based on the information provided - that the Cadco Convection Ovens were directly used to produce food and that utilities consumed by these particular ovens were exempt.

B. Burden of Proof and Statement of the Law.

As a threshold issue, it is the Taxpayer's responsibility to establish that the existing tax assessment is incorrect. As stated in IC § 6-8.1-5-1(c), "The notice of proposed assessment is prima facie evidence that the department's claim for the unpaid tax is valid. The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made." *Indiana Dept. of State Revenue v. Rent-A-Center East, Inc.*, 963 N.E.2d 463, 466 (Ind. 2012); *Lafayette Square Amoco, Inc. v. Indiana Dept. of State Revenue*, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007). Consequently, a taxpayer is required to provide documentation explaining and supporting his or her challenge that the Department's position is wrong. Further, "[w]hen [courts] examine a statute that an agency is 'charged with enforcing . . . [courts] defer to the agency's reasonable interpretation of [the] statute even over an equally reasonable interpretation by another party.'" *Dept. of State Revenue v. Caterpillar, Inc*., 15 N.E.3d 579, 583 (Ind. 2014). Thus, all interpretations of Indiana tax law contained within this decision, as well as the preceding audit, shall be entitled to deference.

Nevertheless, the Department is well aware of the countervailing rule that a "statute must not be construed so

narrowly that it does not give effect to legislative intent because the intent of the legislature embodied in a statute constitutes the law." *General Motors Corp. v. Indiana Dept. of State Revenue*, 578 N.E.2d 399, 404 (Ind. Tax Ct. 1991).

Sales tax is imposed by IC § 6-2.5-2-1, which states in relevant part:

> (a) An excise tax, known as the state gross retail tax, is imposed on retail transactions made in Indiana.
> (b) The person who acquires property in a retail transaction is liable for the tax on the transaction and, except as otherwise provided in this chapter, shall pay the tax to the retail merchant as a separate added amount to the consideration in the transaction. The retail merchant shall collect the tax as agent for the state.

Use tax is imposed by IC § 6-2.5-3-2(a), which states:

> An excise tax, known as the use tax, is imposed on the storage, use, or consumption of tangible personal property in Indiana if the property was acquired in a retail transaction, regardless of the location of that transaction or of the retail merchant making that transaction.

45 IAC 2.2-3-4 further explains:

> Tangible personal property, purchased in Indiana, or elsewhere in a retail transaction, and stored, used, or otherwise consumed in Indiana is subject to Indiana use tax for such property, unless the Indiana state gross retail tax has been collected at the point of purchase.

Therefore, when tangible personal property is used, stored, or consumed in Indiana, use tax is due if sales tax was not paid at the time of the transaction, unless an applicable exemption is available.

An exemption from sales and use tax is provided for tangible personal property purchased for use in direct production of other tangible personal property. This exemption is found in IC § 6-2.5-5-5.1, which states in relevant part:

> (a) As used in this section, "tangible personal property" *includes electrical energy, natural or artificial gas, water, steam, and steam heat*.
> (b) Transactions involving tangible personal property are exempt from the state gross retail tax if the person acquiring the property acquires it for direct consumption as a material to be consumed in the direct production of other tangible personal property in the person's business of manufacturing, processing, refining, repairing, mining, agriculture, horticulture, floriculture, or arboriculture. This exemption includes transactions involving acquisitions of tangible personal property used in commercial printing. (*Emphasis added*).

In the case of electrical usage, 45 IAC 2.2-4-13 explains:

> (a) In general, the furnishing of electricity, gas, water, steam, or steam heating services by public utilities to consumer is subject to tax.
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> (b) The gross receipt of every person engaged as a power subsidiary or a public utility derived from selling electrical energy, gas, water, or steam to consumers for direct use in direct manufacturing, mining, production, refining, oil or mineral extraction, irrigation, agriculture, horticulture, or another public utility or power subsidiary described in IC 6-2.5-4-5 shall not constitute gross retail income of a retail merchant received from a retail transaction. Electrical energy, gas, water, or steam will only be considered directly used in direct production, manufacturing, mining, refining, oil or mineral extraction, irrigation, agriculture, or horticulture if the utilities would be exempt under IC 6-2.5-5-5.1.
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> (c) Sales of public utility services or commodities to consumers engaged in manufacturing, mining, production, refining, oil or mineral extraction, irrigation, agriculture, horticulture, or another public utility or power subsidiary described in IC 6-2.5-4-5, based on a single meter charge, flat rate charge, or other charge, are excepted if such services are separately metered or billed and will be used predominantly for the excepted purposes.
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> (d) Sales of public utility services and commodities to consumers engaged in manufacturing, mining, production, refining, oil or mineral extraction, irrigation, agriculture, or horticulture, based on a single meter charge, flat rate charge, or other charge, which will be used for both excepted and nonexcepted purposes are taxable unless such services and commodities are used predominantly for excepted purposes.

(e) Where public utility services are sold from a single meter and the services or commodities are utilized for both exempt and nonexempt uses, the entire gross receipts will be subject to tax *unless the services or commodities are used predominantly for excepted purposes.* Predominant use shall mean that more than fifty percent (50[percent]) of the utility services and commodities are consumed for excepted uses. (*Emphasis added*).

Therefore, only when 50 percent or more of electricity sold from a single meter is used in an exempt manner, the purchaser/taxpayer is considered to have predominantly used the electricity for exempt purposes and the electricity sold through that meter is wholly exempt from sales tax and use tax. In order to qualify for the exemption, a taxpayer must show that "1) it is engaged in production, 2) it has an integrated production process, and 3) the electricity is essential and integral to its integrated production process." *Aztec Partners, LLC v. Indiana Dep't of State Revenue*, 35 N.E.3d 320, 324 (Ind. Tax Ct. 2015).

In Taxpayer's case, it argues that utilities consumed by "fry freezer, holding cabinets, heat lamps, microwaves, and convection ovens" are exempt from sales tax and that the Department's conclusions to the contrary were wrong.

C. Taxpayer's Food Preparation Equipment.

Taxpayer explains that the following items of restaurant equipment are exempt because they are directly involved in the production of Taxpayer's food products.

- Reach-In Fry Freezer
- Walk-in Cooler
- Holding Cabinets
- Warming Lamps
- Microwave Ovens

Taxpayer has provided food preparation guides designed and prepared to govern the preparation of Taxpayer's food offerings. The "Reach-In Fry Freezer" receives and stores frozen meat at a particular temperature.

The "Walk-in Coolers" are used to hold sliced ham, turkey, and other meats within a particular temperature range. After being held in the coolers, the meats are ready to be used in Taxpayer's "sandwich assembly."

Taxpayer's "Holding Cabinets" are equipped with pans designed to hold "a max of 96 oz." The cabinets "hold" meat which has been roasted and maintains that meat at specific temperatures. Each cabinet has a touchscreen displaying the temperature and time lapsed which is then retained in an electronic "Holding Log." Taxpayer's instructions cautions that this is necessary "to ensure food safety" and comply with federal "Hazard Analysis Critical Control Point" guidance.

Taxpayer's warming lamps are either 500- or 250-watt quartz lamps designed to "maintain an internal [meat] temperature of 138-degree Fahrenheit or higher."

The Microwave Ovens are used to prepare Taxpayer's food offerings. For example, employees are directed to "weigh out [redacted]," "place a slice of [redacted] cheese on top of the [redacted]," and "heat the [redacted] portion in the microwave." Elsewhere, employees are instructed to "place an untoasted sub roll on the counter," distribute [redacted] and cheese across the roll and "place the marked clamshell into the microwave to heat the finished product."

Taxpayer maintains that these five categories of equipment are exempt pursuant to IC § 6-2.5-5-5.1. The Department will agree with Taxpayer if it meets its statutory burden under IC § 6-8.1-5-1(c) of establishing that the Department's assessment was wrong. In order to do so Taxpayer must establish that this equipment is used in the "direct production" of its food items, because the equipment "change[s] the individual food items into new, marketable products that [have] a character and form different from the food items first acquired" and because the equipment is utilized within (not before and not after) Taxpayer's "integrated production process." *Aztec Partners,* 35 N.E.3d at 322, 325. Taxpayer's analysis must meet the "strictly construed" standard. *Tri-States Double Cola Bottling Co. v. Dep't of State Revenue*, 706 N.E.2d 282, 283 (Ind. Tax Ct. 1999).

D. Analysis and Conclusion.

Bearing in mind that this exemption is strictly construed, that Taxpayer has the burden of establishing that the

assessments were wrong, and that exempt equipment must "change the individual food items into new, marketable products that [have] a character and form different from the food items first acquired," the Department is prepared to agree that the cited microwave ovens and the holding cabinets meet the requisite tests. Both Taxpayer's explanation and the specific restaurant information are sufficiently convincing to sustain Taxpayer on this particular issue because what goes into the microwave oven is different from that which comes out and because the microwaves operate *within* Taxpayer's integrated production process. *Aztec Partners,* 35 N.E.3d at 323. In other words, the microwaves are not used prior to production or after production is complete. The holding cabinets are exempt because this equipment operates within Taxpayer's "integrated production process." *Id.* at 325.

The remaining items are a different story; in these cases, the information provided suggests that the devices are used to maintain food in a present state and do not *change* the character and form of the food item.

To the extent that Taxpayer has established that the microwave ovens and the holding cabinets are "directly used" within an integrated production of Taxpayer's food products and/or have a transformative effect on those products, Taxpayer's protest is sustained.

The Department here points out that Taxpayer is not being sustained because it owns and uses microwave ovens. It is being sustained because its microwave ovens are used in Taxpayer's restaurants in a way which has a direct effect on the food item within an integrated process which changes the character and form of that food. Taxpayer is not being sustained because it owns and uses holding cabinets. It is being sustained because the cabinets operate and consume utilities with Taxpayer's integrated production process.

FINDING

Taxpayer's protest is sustained in part and denied in part.

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An html version of this document.